Bonds Versus Letters of Credit

Are You Using the most cost effective method?

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Things are changing quickly in today's economic environment including the cost of posting Letters of Credit to meet various obligations. Traditionally a Letter of Credit has been a more competitive option than obtaining a Surety Bond. With these changes in the economic environment over the last six months, Surety Bonds have become a more viable option and in some cases, frees up cash associated with a traditional Letter of Credit.

If you have a Letter of Credit posted for a performance obligation, you may want to think about replacing your Letter of Credit with a Surety Bond. In today's economic environment the Surety Bond may be the more cost effective way of providing security to utility companies, local jurisdictions and others that may require some form of collateral. In many cases the form of acceptable collateral has been a Letter of Credit, however with the changes in financial institutions we now see lenders reducing the amount of credit they are willing to extend to their customers and increasing the cost of providing a Letter of Credit.

As most people are aware, a Surety Bond is basically a promise to perform by one party to another. In the event the Party (Principal) does not perform to the terms and conditions of a contract or obligation, a third party (Surety) will step in and either fulfill the obligation or make payment to the party requiring the bond (Obligee).

Surety is very different from Insurance. Surety companies do not expect losses and they do require Indemnity of the Principal, meaning the Principal agrees to reimburse the Surety for any losses incurred under the bond(s). Indemnity requirements by the Surety may be Corporate and Personal, depending on the set up of the Corporation, the financials, as well as the bonded obligation.

There are various types of bonds including:

- Court
- Financial Guarantee
- Lease
- License/Permit
- Supply/Install
- Service Contract

There are times that Letters of Credit have been posted where a bond would make better sense:

- Surety rates may be less than what a bank is charging, which often includes fees.
- A bond frees up cash providing a better working capital position as well as creating additional borrowing capacity.
- The Beneficiary of a Letter of Credit may go straight to the bank and demand payment within 72 hours. With a bond, in almost all cases, a claim has to be made to the Surety and an investigation ensues to find out if the Principal failed to perform the obligation of which the bond was provided.
- Typically bonds are not noted in the financial statements as contingent liabilities where Letters of Credit are included.
- A Letter of Credit may be held for up to two years before it is released by the beneficiary - especially if there is a warranty involved.

However a bond will not work in all instances, such as the case with credit enhancement obligations when a Letter of Credit is used to enhance corporate or municipal debt issuance to secure lenders in limited partnership agreements. National surety companies are prohibited by law to support these types of obligations as well as other non-traditional financial guarantees.

There also may be times when a party requiring security will only accept a Letter of Credit as a guarantee of performance. In these cases the party might not have a good understanding of bonds and using them as financial guarantees. Awareness of the role bonds play may enlighten them and change their minds if a bond makes more sense and provides greater benefits due to the Surety's underwriting and pre-qualification process.

The Surety will require financial statements, possibility corporate and personal, to underwrite a given obligation along with additional information.

As part of your next renewal discussion we encourage you to investigate this issue with your broker. Parker Smith & Feek has a strong Surety Department and a Commercial Surety Consultant who would be happy to discuss how you might use a bond to your advantage.

For more information about Commercial Surety please call your Parker, Smith & Feek Account Executive at 425.709.3600

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